No. 12,664

IN THE

United States Court of Appeals

For the Ninth Circuit

Commissioner of Internal Revenue, *Petitioner,* vs. Grace H. Kelham, Leila H. Neill, Ellis M. Moore, Harriet H. Belcher, and Lillie S. Wegeforth, *Respondents.*	

Brief on Behalf of Adolph B. Spreckels and Dorothy C. Spreckels, Taxpayers and Respondents in *Commissioner of Internal Revenue, Petitioner v. Adolph B. Spreckels, et al., Respondents,* No. 12,663.

On Petitions for Review of the Decisions of the
Tax Court of the United States

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PRELIMINARY STATEMENT

This brief is submitted on behalf of Adolph B. Spreckels and Dorothy C. Spreckels (hereinafter referred to as "the taxpayers"), taxpayers and respondents in *Commissioner of Internal Revenue v. Adolph B. Spreckels, Dorothy C. Spreckels, Spreckels-Rosekrans Investment Company, John N. Rosekrans and Alma Spreckels Rosekrans,* No. 12,663

in this Court, on petition for review of the decisions of the Tax Court of the United States in *Adolph B. Spreckels, et al. v. Commissioner of Internal Revenue,* Tax Court Docket Nos. 5628, 5629, 5677 and 5678, reported at 13 T. C. 1079.

Taxpayers were stockholders in the J. D. and A. B. Spreckels Company (referred to in petitioner's brief and hereafter as "Spreckels Company") during the years 1938, 1939 and 1940, as were respondents Kelham, et al., in this case, and the question presented to this Court on review is identical in each case.

Pursuant to stipulation entered into between counsel and approved by this Court on October 25, 1950, it was stipulated that the *Spreckels'* case (No. 12,663) should be held in abeyance pending a final decision in this case, whereupon either party might apply to this Court for a judgment in conformity therewith. It was then further stipulated that counsel for any of the taxpayers and respondents in the *Spreckels'* case should have the privilege of filing a brief on their behalf in this case, and this brief is submitted accordingly.

JURISDICTION

The statement of pleadings and facts upon which the Commissioner relies to establish the jurisdiction of this Court to review the decisions of the Tax Court is uncontroverted. Brief for Petitioner, pp. 1-2.

STATEMENT OF THE CASE

The statement of facts presented by the Commissioner in his opening brief is uncontroverted, and is adopted for the purpose of this brief. Brief for Petitioner, p. 3.

The sole question before this Court is whether, in the case of a corporation having an operating deficit as of February 28, 1913, earnings of the corporation subsequent to that date are available for distribution as taxable dividends, or must first be applied to offset and eradicate the deficit before being deemed "earnings or profits accumulated after February 28, 1913," within the meaning of Section 115(a)(1) of the Internal Revenue Code.

The Tax Court decided that such an operating deficit must first be restored out of subsequent earnings before an accumulation of such earnings can be deemed to exist as a source of taxable dividends.

SUMMARY OF ARGUMENT

It is well established that a corporation which incurs an operating deficit *after* February 28, 1913, can have no accumulation of earnings or profits for distribution as a taxable dividend within the meaning of Section 115(a)(1) of the Internal Revenue Code until this impairment of capital has been removed. This rule was established without express statutory provision in recognition of the general principle that a corporation cannot have earnings available for dividends while its capital stands impaired by losses. The reason behind this rule as to post-1913* deficits applies with equal force to deficits incurred at any time during the existence of a corporation, and it is completely illogical to apply a different rule to pre-1913 deficits, unless Congress has indicated an intent to draw an arbitrary line at February 28, 1913, for all purposes.

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*The terms "post-1913" or "pre-1913" will be used hereafter to refer to events or conditions existing after February 28, 1913, or before March 1, 1913, respectively.

From an examination of the legislative history behind Section 115, it appears that the phrase "earnings or profits accumulated after February 28, 1913," was introduced into the definition of a "dividend" for the purpose of allowing a tax free distribution of earnings and profits accumulated before the effective date of the first income tax law. The equivalent of Section 115(b) was added later to set up a presumption as to the source of dividends, and the complementary phrase "earnings or profits accumulated * * * before March 1, 1913," was introduced by way of spelling out the application of the presumption to such profits. These provisions do not indicate a congressional intent to freeze February 28, 1913, balance sheets for the purpose of computing operating deficits. On the contrary, the Supreme Court of the United States has directly refused for other purposes to erect such an arbitrary point of reference from the statutory use of the phrase "earnings or profits accumulated after February 28, 1913."

The holding of the Tax Court was, therefore, correct.

ARGUMENT

The Tax Court held that an operating deficit existing on February 28, 1913, must be restored from subsequent earnings before a corporation has "earnings and profits accumulated since February 28, 1913," for distribution as taxable dividends. The taxpayers are in complete agreement with the carefully reasoned majority opinion of that Court by Judge Turner. Principal attention will, therefore, be given to the arguments advanced by the Commissioner in his opening brief.

The Commissioner makes three principal arguments: (1) That the Tax Court's construction is untenable because it

creates an *exemption* by unwarranted implication (Brief for Petitioner, pp. 15-21); (2) that neither the general corporate principles nor the cases involving post-1913 deficits relied on by the Tax Court have any bearing on the instant problem (Brief for Petitioner, pp. 21-28); and (3) that the Tax Court has misconstrued Section 115(a)(1) in that the effect of its holding is to treat the phrase "earnings or profits accumulated after February 28, 1913," as surplusage without meaning or effect (Brief for Petitioner, pp. 11-15). These arguments are listed in the order in which they will be considered in this brief, rather than the order in which they are set out in the Commissioner's brief.

A. The Cases Requiring Restoration of Post-1913 Operating Deficits Give Judicial Recognition for Tax Purposes to a Principle Which Is Equally Applicable to Pre-1913 Operating Deficits.

It appears that the issue of this case has never before been squarely presented to a court for decision.* In construing the definition of "dividends" in Section 115(a)(1)

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*In *Chapman v. Anderson,* 11 F. Supp. 913 (S.D. N.Y. 1935), the Court held that certain corporate distributions were non-taxable because an operating deficit existing on March 1, 1913, had not been restored; but neither party disputed the necessity for restoring the deficit. In *Hadden v. Commissioner,* 49 F.2d 709 (C.C.A. 2d 1931), the Court held corporate distributions non-taxable to the extent that net operating losses after March 1, 1913, had not been restored; but, with the acquiescence of both parties, and without any discussion of the point, the Court gave no effect to the corporation's operating deficit on March 1, 1913. *Hoffman v. United States,* 53 F.2d 282 (Ct. Cls. 1931), involved a pre-1913 deficit, but was decided on the erroneous premise that any deficit could be ignored if the distribution was out of earnings of the current year. This premise has clearly been overruled; see cases cited in text, *infra,* page 6. *J. L. Washburn,* 16 B.T.A. 1091 (1929), required restoration of a deficit, a portion of which was apparently incurred between 1907 and March 1, 1913, but no consideration was given to any possible distinction between pre-1913 and post-1913 operating losses.

it is, therefore, appropriate to consider how the definition has been applied in other instances. The Tax Court did this, and its holding is a logical and necessary extension of a well-settled rule.

Both the Commissioner and the dissenting judges in the Tax Court admit that a corporation which incurs an operating deficit *after* March 1, 1913, can have no accumulation of earnings or profits within the meaning of Section 115(a)(1) of the Internal Revenue Code until the impairment of capital has been restored by subsequent earnings. R. 104; Brief for Petitioner 24. Numerous cases have so held. *E.g., Foley Securities Corp. v. Commissioner,* 106 F.2d 731 (C.C.A. 8th 1939); *Louise Glaswell Shorb,* 22 B.T.A. 644 (1931); *J. L. Washburn,* 16 B.T.A. 1091 (1929); *cf. Willcuts v. Milton Dairy Co.,* 275 U.S. 215 (1927); *see, also* G. C. M. 1552, VI-1 C.B. 10 (1927); L.O. 942, 1 C.B. 300, 301 (1919).

Two things are particularly significant about this rule regarding the restoration of post-1913 operating deficits: (1) It was established without the aid of any express statutory exemption, and (2) it is a recognition and application of a fundamental principle of corporation law, namely, that dividends paid in the face of an operating deficit are a return of capital.

As stated by the Board of Tax Appeals in *Loren D. Sale,* 35 B.T.A. 938 (1937), at page 941:

> "The statute* does not provide that impaired capital or paid-in surplus must be restored before earnings are available for the distribution of a taxable dividend.

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*The case involved Section 201 of the Revenue Act of 1924, which contained provisions substantially similar to Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

That rule of law was laid down by the Board and the courts, which had in mind the fundamental principle that a corporation, the capital of which had been impaired by losses, can never have any accumulated earnings until its capital is restored. Corporations, of course, were well known long before March 1, 1913, the effective date of the income tax. Likewise, the concepts of capital and impairment of capital were fixed in the law and generally understood. The provisions of the revenue acts have not changed the law in respect of capital or impairment of capital. * * *''

To the same effect is a Memorandum of the General Counsel of the Bureau of Internal Revenue:

''The term 'dividend' is defined by Section 201(a) of the Revenue Act of 1926* as any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913. Although it is provided in section 201(b) that for the purposes of the Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits, there can be no accumulation of profits until an operating deficit is made good. *As there was no surplus from which a dividend could have been paid, it necessarily follows that the distribution must have been out of capital.*'' (Emphasis added) G.C.M. 1552, VI-1 C.B. 10 (1927).

The very existence of this uncontroverted rule as to post-1913 operating deficits indicates the fallacy of two of the Commissioner's arguments:

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*Sections 201(a, b) of the Revenue Act of 1926 contained provisions substantially similar to Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

(1) The Commissioner contends that the Tax Court's construction of Section 115(a)(1) creates an *exemption* by implication. This, he urges, violates the rule that exemptions may not rest on implication and is contrary to the congressional policy of taxing all distributions of post-1913 earnings and profits. Brief for Petitioner, pp. 15-21.

It is apparent that if the holding of the present Tax Court creates an exemption, the rule as to post-1913 deficits must also be regarded as creating an exemption.* The validity of this argument of the Commissioner may, therefore, be determined by applying it to the rule as to post-1913 deficits. As noted, this rule of law, requiring post-1913 operating deficits to be restored before a distribution is considered to be out of accumulated earnings and profits, was established without the aid of an express statutory exemption. How is it that the line of reasoning indulged in by the Commissioner did not prevent this rule from arising? The obvious answer is that neither this rule nor the rule adopted by the Tax Court as to pre-1913 deficits *exempts* dividends from earnings accumulated after March 1, 1913, from taxation. Both rules (which are really but one) simply recog-

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*This may be illustrated by the following situations: (1) Corporation A was organized in 1914, had an operating deficit of $10,000 by the end of 1914, broke even each year thereafter until 1920, had net profits of $10,000 in 1920, and at the end of 1920 made a distribution of $10,000 to its stockholders. (2) Corporation B was organized in 1912, had an operating deficit of $10,000 on February 28, 1913, broke even each year thereafter until 1920, had net profits of $10,000 in 1920, and at the end of 1920 made a distribution of $10,000 to its stockholders.

It is well settled that the distribution of Corporation A would *not* have been a taxable dividend. Correspondingly, the Tax Court below held that the distribution of Corporation B would *not* have been a taxable dividend. Each corporation realized earnings after 1913 equal to the amount of its distribution. If it is an "exemption" to hold either distribution non-taxable, it is equally an "exemption" to hold the other non-taxable.

nize that a distribution while capital is impaired as a result of operating losses is in reality a return of capital, and not ordinary taxable income at all. No "exemption" is involved.

It should be noted that in making this argument the Commissioner repeatedly cited the case of *Helvering v. Canfield,* 291 U.S. 163 (1934). Brief for Petitioner, pp. 15, 16, 17, 18, 19. The Commissioner relies on statements in that case indicating that the exemption as to pre-1913 earnings in the statute* is to be strictly construed to effectuate the congressional plan to prevent profits accumulated after that date from escaping taxation. This reliance is seriously misplaced.

The *Canfield* case involved a corporation with a *surplus* on February 28, 1913, operating losses for the years 1915 and 1916, and net earnings for years subsequent to 1916. The Supreme Court held that the operating losses should be charged against the surplus (which exceeded the total of the losses) and did not have the effect of reducing profits earned thereafter, and accordingly found certain distributions in 1923 to be taxable in full.

The Court itself was careful to point out the very reasons why the statements relied on are not at all in point with respect to the instant case. Thus, the Court said (p. 167):

> "The argument that the surplus of March 1, 1913, constituted capital is unavailing. We are not here concerned with capital in the sense of fixed or paid-in capital, which is not to be impaired, or with the restoration of such capital where there has been impairment. *No case of impairment of capital is presented.*

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*The case involved Sections 201(a, b) of the Revenue Act of 1921 which contained provisions substantially similar to Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

> We are dealing with a distribution of accumulated profits.'' (Emphasis added)

And again at the end of the same paragraph (p. 167):

> ''There is no question here of the receipt of 'capital.' ''

The Court was clearly conscious of the very distinction which dooms the Commissioner's argument that the Tax Court below created an exemption by implication. The *Canfield* case, as noted by the Court, did *not* involve an impairment of capital* and therefore raised no question of a return of capital. Exactly the opposite is true of the instant case. The *Canfield* case was dealing with the *exemption* as to a pre-1913 surplus. This was a matter of legislative grace† and properly called for strict construction. By way of contrast, the instant case turns not on an exemption but on the fundamental concept that a return of capital is not a taxable dividend. The language quoted (*supra,* pp. 9-10), indicates that the Supreme Court would have reached a contrary result if impairment of capital rather than pre-1913 surplus had been involved.

The *Canfield* case not only fails to support the Commissioner's argument—it clearly demonstrates the error therein.

(2) The Commissioner also argues that neither general corporation principles nor cases involving post-1913 deficits are helpful in deciding the instant case. Brief for Petitioner, pp. 21-25.

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*As will be discussed in Part B of the Argument, *infra,* pp. 16-17, in finding that no case of impairment of capital was involved, the Court in the *Canfield* case looked to the accounting period from the time of the corporation's inception and thereby *also* undermined the Commissioner's argument that March 1, 1913 has been established as a dividing line fixing the state of a corporation's capital for tax purposes.

†See *Lynch v. Hornby,* 247 U.S. 339 (1918).

It may be admitted that the congressional definition of a dividend does not necessarily conform to general corporation law. However, in the situation most closely analagous to that of the instant case, i.e., in the case of post-1913 operating deficits, the fundamental principles of corporate law as to when a distribution represents a return of capital have been recognized and applied, in the absence of an express statutory declaration. In the light of this fact, it can scarcely be correct, as suggested by the Commissioner (Brief for Petitioner, pp. 21-22), that it "carries not the slightest weight of persuasion" that his contention is plainly contrary to fundamental principles of corporation law.

The general principle recognized by the rule as to post-1913 deficits is that a distribution while capital is impaired by operating losses is a return of capital. Capital is as much impaired by pre-1913 operating deficits which have not been restored as by post-1913 deficits. In short, the principle behind the settled rule as to post-1913 deficits applies with equal force to pre-1913 deficits; the authorities establishing the former rule should be regarded as controlling unless a congressional intent to draw an arbitrary line at February 28, 1913 for this purpose can be found.

B. There Is No Basis in the Statute for a Distinction Between the Impairment of Capital After February 28, 1913, and the Identical Impairment Before That Date.

The holding of the Tax Court accords the same effect to operating deficits whether incurred before or after March 1, 1913. The only argument advanced by the Commissioner for a *distinction* in the treatment of post-1913 operating deficits and pre-1913 deficits is that the phrase

"earnings or profits accumulated after February 28, 1913" in Section 115(a)(1) of the Internal Revenue Code would otherwise be completely superfluous and without meaning. Brief for Petitioner, pp. 11-15.

Section 115 of the Internal Revenue Code contains the following provisions:

> "DISTRIBUTIONS BY CORPORATIONS.
>
> "(a) *Definition of Dividend.*—The term 'dividend' * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or, (2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made.*
>
> "(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against, and reduce the adjusted basis of the stock provided in Section 113."

The Commissioner seems to argue that Section 115(b) is the operative provision to protect pre-1913 earnings from being taxed when distributed; that the phrase "accumulated after February 28, 1913" in Section 115(a)(1) does not serve this purpose; and that this phrase therefore has no meaning unless the construction adopted by the

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*See footnote †, *infra,* p. 14.

Tax Court is rejected. It is submitted that the argument is without merit.

Subdivision (a) defines the term "dividend" for tax purposes. As an expression of the congressional purpose to allow tax-free distribution of any pre-1913 surplus, the definition includes only distributions out of earnings or profits accumulated after February 28, 1913. Subdivision (b) sets up presumptions as to the source of corporate distributions. The second sentence of subdivision (b) is merely an application of the general presumption to the specific case of pre-1913 earnings, i.e., they may be distributeed tax-free only after all post-1913 earnings have been distributed.

The error of the Commissioner's contention is further emphasized by the legislative history behind these provisions. The first income tax law, the Revenue Act of 1913 (33 Stat. 166), provided that "net income * * * shall include gains, profits, and income derived from * * * dividends * * *" but contained no definition of dividends. Accordingly, the Treasury Department adopted the practice of treating dividends received by stockholders after February 28, 1913 as fully taxable even though entirely out of earnings of a corporation prior to that date.

Doubt as to the constitutionality and justness of this practice induced Congress to include the following provision in the Revenue Act of 1916 (39 Stat. 756):

> "*Provided,* that the term 'dividends' as used in this title shall be held to mean any distribution made * * * by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, * * *"

This definition has been continued in substantially identical form down to the present definition in Section 115 (a) (1) of the Internal Revenue Code. The congressional purpose in adding this definition was clearly to allow the tax-free distribution of pre-1913 earnings and profits. As expressed by the Board of Tax Appeals in *M. H. Alworth Trust,* 46 B.T.A. 1045 (1942),* at page 1047:

> "* * * In acts prior to the Revenue Act of 1936,† the term 'dividend' was defined as 'any distribution made by a corporation to its shareholders, whether in money or other property, out of its earnings or profits accumulated after February 28, 1913.' *Certainly there is nothing in the definition to indicate that Congress had in mind any limitation or change in the commonly accepted meaning of the term 'dividend,' except to exclude distributions from earnings or profits accumulated prior to February 28, 1913.* * * *" (Emphasis added)

Under the 1916 Act, the source of a distribution (i.e., whether from earnings accumulated before or after March 1, 1913) was apparently determined in accordance with the designation of the payment by the corporation. To change this, Congress, in 1917, added a conclusive presumption as to the source of corporate distributions.‡

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*Reversed on other grounds, *Helvering v. Alworth Trust,* 136 F.2d 812 (C.C.A. 8th 1943).

†Section 115(a)(2) was added to the definition by the Revenue Act of 1936. By this subsection (quoted in part, *supra,* p. 12) a distribution out of earnings or profits of the taxable year is a taxable dividend *without regard to the amount of the earnings and profits at the time the distribution was made.* Application of this subsection is not involved under the facts in the instant case.

‡For discussion of the reasons leading to the changes of the 1916 and 1917 Acts, see *Edwards v. Douglas,* 269 U.S. 204, 211-213 (1925).

The definition of a "dividend" from the 1916 Act was repeated substantially word for word as subdivision (a) of Section 31 of the Revenue Act of 1917 (40 Stat. 300), and subdivision (b) was added, containing the following provisions:

> "Any distribution * * * in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, * * * but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed * * * after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. * * *"

The two subdivisions of Section 31, insofar as they relate to the instant case, have been continued in substantially the same form down to the present and are now Sections 115(a)(1) and 115(b) of the Internal Revenue Code.

From the foregoing it is apparent that the phrase "earnings or profits accumulated after February 28, 1913" was inserted in the definition of "dividends" as the operative provision to exempt pre-1913 earnings from taxation. The holding of the Tax Court in no way ignores or interferes with this intended meaning and effect; it simply declines to imply an effect never intended. The reference to "earnings or profits accumulated * * * before March 1, 1913," in subdivision (b) was added later and is merely a complementary provision employed in spelling out the application of the presumption to pre-1913 earnings.

The focus on March 1, 1913 does not indicate an intent to draw a line at this date as to the existing state of corporate capital. The statutory contrast between distributions out of earnings accumulated before 1913 and those accumulated after 1913 is not at all left meaningless by the Tax Court's holding; the former are non-taxable distributions, the latter are taxable "dividends."

The error of the Commissioner's position in this respect is also demonstrated by *Helvering v. Canfield,* 247 U.S. 339 (1934), previously discussed (*supra,* pp. 9-10). The Commissioner seeks to measure the existence or non-existence of corporate earnings or profits for the purpose of taxable distributions by operations from March 1, 1913 only, rather than over the life of the corporation. If this were correct, a corporation with net losses since February 28, 1913 would come within the rule requiring restoration of post-1913 operating deficits and a surplus or deficit existing on March 1, 1913 would not affect the calculation. The same argument was advanced by the taxpayers in the *Canfield* case and rejected by the Supreme Court. In that case the corporation had net operating losses from March 1, 1913 to the end of 1917, yet the Court refused to apply subsequent earnings to restore the deficit *computed over this period.* Instead, the Court said that no case of impairment of capital was presented,* i.e., it looked to the life of the corporation and found no operating deficit because of the pre-1913 surplus. It cannot logically be contended that the existence or non-existence of a deficit should be computed over a lesser period simply because pre-1913 operations resulted in a net loss. A distribution while capital is impaired (which must be computed over

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*See quotation from opinion, *supra,* p. 9.

the life of the corporation) is not out of earnings or profits, but is a return of capital.

CONCLUSION

The decisions of the Tax Court should be affirmed.

Respectfully submitted,

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Dated: March 2, 1951